COUNTY OF LOS ANGELES
DEPARTMENT OF AUDITOR-CONTROLLER

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October 17, 2001

TO: Supervisor Michael D. Antonovich, Mayor
Supervisor Gloria Molina
Supervisor Yvonne Brathwaite Burke
Supervisor Zev Yaroslavsky
Supervisor Don Knabe

FROM: J. Tyler McCauley
Auditor-Controller

SUBJECT: **DEPARTMENT OF MENTAL HEALTH – REVIEW OF CASH FLOW LOAN PROGRAM**

At the request of the Chief Administrative Office, we conducted a review of the Department of Mental Health's (DMH) Board-approved Cash Flow Loan Program (CFLP). The purpose of the CFLP is to provide County contract mental health care providers access to funds during the delay between their provision of service and their receipt of payment from State and federal funding sources. The loans are provided interest free and are often not fully repaid because of the need to replace repaid loans with new loans.

During Fiscal Year (FY) 2000-2001, DMH disbursed $151.4 million in loans. As of August 2001, DMH's outstanding loan balance for loans issued during FY 2000-2001 and FY 2001-2002 totaled $71.9 million. Our review consisted of interviewing departmental personnel, reviewing available documentation, and evaluating loan processing, monitoring, and accounting practices.

Summary of Findings

The CFLP is difficult to manage and requires expertise generally outside the scope of DMH's mission. The County has incurred losses and is at risk of incurring significant future losses if the program continues to operate as it currently does. The following are noteworthy facts and points of concern:

- The need for the program is caused by delays in providers receiving State and federal reimbursement for services provided. It can take five months or longer from the date of service to receive payment.

- Eighty-four providers received loans during FY 2000-2001. Thirty providers had outstanding balances as of August 2001 and were on DMH's Watch List because they have shown indications of financial difficulties.

- Over the past five years, the County has incurred approximately $2.8 million in loan related losses. Losses occur when providers are unable to repay loans because anticipated services were not provided.

- The County has significant future risk exposure related to $9.9 million in currently outstanding loans. Of this total, approximately $6.0 million represents unpaid loans from FY 1999-00 and prior years. While it is highly likely that future losses will occur, the ultimate loss is unknown at this time, but will probably be less than the $9.9 million.

  It should be noted that the County faces other loss exposures in administering State and federal funded programs. For example, audit disallowances can result in losses to the County if a provider cannot pay them.

- In addition to loan losses, the program costs the County $1.9 million annually in lost interest revenue. DMH believes that the benefits of the program justify these costs.

- DMH does not have procedures to ensure the County's risk exposure is kept to a minimum. This is an unusual program and County staff may not have the necessary skill sets or resources to effectively manage the program.

In order to minimize future risk to the County, we have recommended that DMH take the following actions:

- Work with State and federal funding sources and the providers to streamline the reimbursement process.

- Explore alternatives to County loans such as requiring providers to obtain commercial loans, or State or federal agencies funding the loans.

If the Board decides to continue the CFLP, it should require DMH to strengthen its approval, monitoring, and loan collection activities by:

- Requiring providers to provide collateral to protect the County's interests.

- Increasing loan monitoring efforts.

- Considering hiring a qualified third-party to administer the program.

- Restricting loan amounts to only what is necessary for the providers to operate.

In addition to implementing the recommended actions listed above, DMH needs to ensure providers with substantial assets do not receive CFLs, work with County Counsel to determine if use of Realignment funds to cover loan losses is appropriate, stop retroactive contracting and related loan activities, and improve its accounting for CFLs.

Review of Report

We discussed our findings and recommendations with DMH representatives. In general, DMH agrees with the report. Their response is attached.

If you have any questions, please call me or your staff may call Pat McMahon at (213) 974-0729 or DeWitt Roberts at (213) 974-0301.

JTM:PTM:DR:IC

Attachment

c: David E. Janssen, Chief Administrative Officer
Dr. Marvin Southard, DSW, Director, Department of Mental Health
Lloyd W. Pellman, County Counsel
Mark J. Saladino, Treasurer and Tax Collector
Violet Varona-Lukens, Executive Officer
Public Information Office
Audit Committee (6)

DEPARTMENT OF MENTAL HEALTH
CASH FLOW LOAN PROGRAM REVIEW

COMMENTS AND RECOMMENDATIONS

BACKGROUND

The Department of Mental Health (DMH) has had a Cash Flow Loan Program (CFLP) to provide County contract mental health care providers access to funds to help them meet their cash requirements during the delay between their provision of service and receipt of payment from third party funding sources (State and federal). The loans are provided interest free. However the loans are often not fully repaid because of the need to replace repaid loans with new loans. Additionally, if not enough services or the wrong types of services are provided, the provider will not have sufficient funds to repay the loans and will have to repay them from some other source, or the County loan will not be repaid at all.

DMH's Financial Services Bureau is responsible for approving and issuing CFLs. During Fiscal Year (FY) 2000-2001, DMH disbursed $151.4 million in loans to 84 providers. As of August 2001, DMH had outstanding loans for FY 2000-2001 and FY 2001-2002 totaling $71.9 million.

During February 2001, DMH began preparing a Watch List to monitor potential problems concerning the financial viability of providers. One of the criteria for inclusion on this list is failure to produce enough or the right kind of services. Examples of other criteria include CPA reported going concern issues, program reviews and Auditor-Controller (A-C) investigations indicating provider problems, and reported difficulty in meeting payroll obligations. Eighty-four providers received loans during FY 2000-2001. Thirty had outstanding balances as of August 2001 and were on the Watch List because they had shown indications of financial difficulties.

SCOPE

At the request of the Chief Administrative Office (CAO), we conducted a review of DMH's CFLP to determine the collectibility of the loans. Our review consisted of interviewing departmental personnel, reviewing available documentation, and evaluating loan processing, monitoring, and accounting practices. We used DMH's Watch List to help focus our audit on problem loans.

LOAN STATUS AND MONITORING

Loan Status

Over the past five years, mental health providers defaulted on $2.8 million in CFLs. Based on our review of DMH's outstanding CFLs, we estimate the County has a potential risk exposure related to an additional $9.9 million in currently outstanding loans. As these loans are recorded as an asset and included in fund balance on the County's financial records, if they are not collectible, there will be a negative budgetary effect.

We noted thirteen providers are not producing enough services and/or the right types of services to repay the full amount of their loans. In addition, two providers are under investigation by the Auditor-Controller (A-C) and there are tentative findings suggesting serious problems that could result in closure or curtailment of operations. In another instance, a provider's CPA has expressed concern regarding the provider's ability to continue operating. Twelve providers are operating at a loss. One provider has a reported negative cash balance. Eight have cash flow problems or often have difficulty meeting payroll obligations. Two have a negative net worth. Because of serious issues with cost reporting, DMH has requested that we perform a financial audit of two additional providers. Some of these providers had financial problems in more than one category.

In addition to the current loan amounts due, included are $6.0 million in unpaid loans from FY 1999-2000 and prior years. The $9.9 million represents the total outstanding loans at risk. The actual future loss in all probability will be a lesser amount.

It should be noted that the County faces other loss exposures in administering State and federal funded programs. For example audit disallowances can result in losses to the County if a provider cannot pay them.

Loan Monitoring

The CFL Program is difficult to manage. DMH does not have written policies and procedures governing the monitoring and collection of cash flow loans and there is a need to improve program monitoring to minimize losses. DMH should develop policies and procedures that include:

- Requiring collateral for the loans.
- Periodic review and enhancement of the management reports used to monitor the status of delinquent loans.
- Progressive loan collection activities, such as issuing monthly delinquent notices and loan restructuring.
- Providing remittance notices, based on data received from State, federal, and other agencies, that will inform the providers whether their pending claims have been paid and to permit the providers to stay apprised of their loan repayment obligations.
- Notification to the Board of Supervisors and initiation of immediate action to minimize the County's risk when a provider shows signs of defaulting.

- Reconciling amounts on their internal ledgers to the County's centralized accounting records (CAPS).

This is an unusual program and County staff may not have the skill sets or resources to effectively manage the program. Accordingly, hiring a third party administrator to manage the program should be considered. The third party administrator would operate the program similar to a banking operation with strict collateral, reporting and monitoring procedures.

Loan Status and Monitoring Conclusion

The CFL Program is at best difficult to manage and, not only subjects the County to loan losses, but is also costing the County approximately $1.9 million annually in lost interest earnings because the loans are interest free. DMH has incurred $2.8 million in CFL losses. In addition, the County may incur additional losses. This indicates a need to determine whether the risk of making CFLs to some or all providers can be shifted either to the program sponsors (State or federal) or to commercial lenders who are more able to manage the risk. In addition, if it is decided to continue the CFL Program, DMH will need to significantly improve its monitoring ability and activity. Consideration should also be given to hiring a qualified third party to administer the Program.

Recommendations

1. The Board of Supervisors instruct DMH to determine whether the risk of making CFLs to some or all providers can be shifted either to the Program sponsors (State or federal) or to commercial lenders who are better able to manage the risk.

If the Board of Supervisors decides to have DMH continue to make loans:

2. The Board of Supervisors direct DMH to strengthen its approval, monitoring, and loan collection activities by:

-- Requiring collateral for loans.

-- Periodically reviewing and enhancing the management reports used to monitor the status of delinquent loans.

-- Adopting formal policies and procedures for monitoring and collecting outstanding cash flow loans.

-- Developing progressive loan collection activities, such as issuing monthly delinquent notices and loan restructuring.

- **Providing remittance notices, based on data received from State, federal, and other agencies, that will inform the providers whether their pending claims have been paid and to permit the providers to stay apprised of their loan repayment obligations.**

- **Sending a notice to every Board office and initiate immediate action to minimize the County's risk when a provider shows signs of defaulting.**

- **Performing periodic reconciliations of amounts on their internal ledgers to CAPS.**

3. DMH consider hiring a third party to administer the CFL Program.

STATE AND FEDERAL REIMBURSEMENT

The need for the program is caused by delays in providers receiving State and federal reimbursement for services provided. It can take five months or longer from the date of service to receive payment.

In order to minimize the amount of loans and risk to the County, DMH should work with State and federal funding sources, as well as providers, to streamline the reimbursement process.

Recommendation

4. DMH work with State and federal funding sources, as well as providers, to streamline the reimbursement process.

LOANS TO PROVIDERS WITH SUBSTANTIAL ASSETS

DMH provides CFLs to providers that do not appear to need them. For example, we noted that one provider received $2.5 million in CFLs during 2000-01, while possessing $2.9 million in cash reserves as of June 30, 2000. As previously indicated, the CFL program costs the County lost interest earnings. Loaning funds above the necessary requirement costs the County more interest earnings and results in windfall interest earnings to the providers. DMH needs to include in its CFL policies and procedures a provision to ensure that providers who have sufficient cash or cash equivalents to fund operations do not receive CFLs and that the CFL amounts are kept to a minimum level.

Recommendation

5. DMH include in its CFL policies and procedures a provision to ensure that providers that have sufficient cash or cash equivalents to fund operations do not receive CFLs and that the CFL amounts are kept to a minimum level.

REALIGNMENT FUNDS

DMH may not be using its Realignment funds in accordance with their intended purpose. The Bronzan-McCorquodale legislation of 1991 realigned responsibility for nearly all mental health programs from the State to the counties. To fund these programs, the State reallocated sales tax revenues to the counties. Counties are required to maintain a level of financial support for health services at least equal to the amounts specified in the legislation. Last fiscal year, DMH received and expended approximately $300 million in Realignment funds, and its Maintenance of Effort (MOE) requirement was $22.3 million.

DMH covers cash flow loan losses with Realignment Trust funds, a practice that County Counsel has not reviewed to ensure it complies with the Realignment legislation. In addition, with this approach, there is still a loss of funding because the total amount of funding eventually available for mental health services is reduced.

Because the loan losses are not directly tied to providing patient care, the legality of using Realignment funds for this purpose could be questioned. Accordingly, DMH, in conjunction with County Counsel, should review the legality of utilizing Realignment funds to cover loan losses.

Recommendation

6. **DMH not use the Realignment Trust Fund to reimburse the General Fund for loan losses until the legality of this practice is established.**

RETROACTIVE CONTRACTS

We noted that DMH enters into informal agreements with their providers to initiate services in advance of obtaining a Board approved contract amendment. Because this occurs outside of the normal budgetary process, it affects DMH's ability to plan and effectively manage the CFLP. For example, one recent contract amendment submitted by DMH to the Board for FY 2000-2001 activity was retroactive back to July 2000. In addition, there are several amendments related to activity initiated at the beginning of this fiscal year being readied for submission to the Board. In these situations, there is a separation of the process of developing or expanding mental health programs and the County's annual planning and budget cycle, as well as a violation of Board policy.

Recommendation

7. **DMH comply with Board policy regarding retroactive contracting.**

ACCOUNTING PRACTICES

DMH's accounting treatment for this loan activity and the related losses is not easily identifiable in the County's financial statements, nor is the risk involved highlighted. Loan losses are treated as revenue reductions and are not readily identifiable in the revenue totals which are comprised of numerous unrelated transactions. To facilitate monitoring and readily identify losses, losses should be posted to a unique, specific expenditure account. In addition, loan balances are included with other amounts due the County at year-end rather than accounted for as a discrete receivable.

Recommendation

8. **DMH post loan losses to a unique, specific expenditure account and account for loan balances as a discrete receivable.**

COUNTY OF LOS ANGELES

MARVIN J. SOUTHARD, D.S.W.
Director

DAVID MEYER
Chief Deputy Director

RODERICK SHANER, M.D.
Medical Director

DEPARTMENT OF MENTAL HEALTH

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Reply To: (213) 738-4601
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October 15, 2001

TO: Supervisor Michael D. Antonovich, Mayor
Supervisor Gloria Molina
Supervisor Yvonne Brathwaite Burke
Supervisor Zev Yaroslavsky
Supervisor Don Knabe

FROM: Marvin J. Southard, D.S.W.

SUBJECT: **DEPARTMENT OF MENTAL HEALTH – REVIEW OF CASH FLOW LOAN PROGRAM**

The Auditor-Controller's *Review of Cash Flow Loan Program* for the Department of Mental Health accurately commented that the loan program is difficult to manage, and requires lending expertise generally outside the scope of DMH's mission. Nonetheless, the historic and successful use of community-based organizations to provide contracted mental health services creates the necessity of finding a way to assist these agencies with their cash flow working capital needs. The growth from FY 1999-00 to FY 2000-01 was $31.3 million or 99% in State EPSDT, and $36.0 million or 26.6% for Federal Financial Participation reimbursements for services.

The report provides the opportunity to assess where we are with our strategy of supporting community-based organizations in three ways: 1) advancing funds for program start-up; 2) advancing funds in anticipation of Federal or State reimbursement; and 3) other advances or delayed recoupment of County funds. and how best to proceed. I will keep you informed, as we discuss and develop our strategies in balancing the programmatic and fiduciary needs of the service delivery system and the financial and other risks. Initial steps are being taken. The County Administrative Office has established a working group including the Auditor-Controller and the County Counsel, and is already working with the Department in identifying specific actions to improve contractor accountability in this area. The Department will work closely with this work group in developing a corrective action plan.

We will continue to explore options with State and Federal funding sources to streamline the reimbursement process. The major barrier in this area is the limitations of the Department's Management Information System that does the billing to the State and Federal programs. You may be aware that the Department is working with the County Chief Information Office in developing a RFP for a new system, including claim adjudication. The present status of those efforts is the engagement of a firm with system development expertise to prepare that RFP. We will explore processes for supporting other alternative community-based organizations.

I will be seeking Board direction regarding the Auditor-Controller's Recommendation #1 to the Board:

1. The Board of Supervisors instruct DMH to determine whether the risk of making CFLs to some or all providers can be shifted either to the Program sponsors (State or Federal), or to Commercial lenders who are better able to manage the risk.

Specifically, direction regarding the Board's position about requiring collateral, directing resources to loan monitoring efforts, and the hiring of a qualified third-party to administer the program will be of assistance. The CAO presently has a work group addressing the loan issue, and the recommendations of this CAO group will be of great assistance to your Board and this Department.

Also, we will work with County Counsel to determine the appropriateness of using Realignment funds to cover the loan losses. Finally, retroactive contracting will only be done at the direction of your Board.

I concur with all recommendations and will develop an action plan for Recommendations 2, 3, 4, 5, 6, 7 and 8, along with any additional actions after your Board's consideration of Recommendation #1.

I would like to express my appreciation to the Auditor-Controller, CAO and the Department's financial personnel who contributed to the development of this report.

MJS:FSB:glp

c: Executive Group
~~J. Tyler McCauley~~
David Janssen
Rich Mason

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